Statement of Congressman Michael N. Castle

Capital Markets Subcommittee Hearing on "Mutual Funds: Who's Looking Out for Investors?"

November 4, 2003

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing before the Capital Markets Subcommittee today. These hearings are essential and the industry must take note of the concerns that are being raised. Behavior will change but we must put the tools in place to ensure this will not happen again five to ten years from now. I hope each one of us remembers what we are saying here today and the importance of addressing this issue. When we begin to formulate regulations and legislation, we must approach it with the same vigor we are addressing this issue with today and not let it get watered down in politics. Protecting investors is our end goal, but we must fully evaluate this situation to ensure we make the proper changes the first time, we can not afford to be wrong.

The average American family choose to invest in mutual funds. Two decades ago, only 6 percent of American households had mutual fund shares valued at $134 billion. Today, half of all American families have $7 trillion at stake, more than a 500 percent increase in the last twenty years. Mutual funds represent about 10 percent of the total financial assets of the U.S. population. The number of funds have grown from less than 500 mutual funds in 1980 to approximately 8,000 mutual funds today.

This committee, and specifically Chairman Baker, has shown leadership in reforming mutual funds and addressing abuses. In July, the Financial Services Committee approved H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act," which seeks to improve transparency for investors and strengthen funds' corporate governance standards. This is a good start, but obviously more remains to be done.

In evaluating and improving the mutual fund industry a number of key issues must be addressed, in short order, to protect the small investor. Issues that must be scrutinized include late trading, market timing, as well as oversight and regulation. Favoritism to big investors and violating ethical and legal codes rob the average investor who depends on their investments for costs such as education and retirement.

First, late trading is not only an improper advantage for large fund investors, it is illegal. Late trading has allowed some big fund investors to take advantage of the current day's price on orders to buy or sell shares placed after the close of the New York markets, when proper procedure would be to carry out the orders at the following day's price. Some have likened this practice to "'betting today on yesterday's horse race' -- knowing ahead of time what the outcome would be." I understand the Securities and Exchange Commission (SEC) is reviewing a proposal to require that funds, not brokers, receive orders by the close of the market. This would be a good first step in addressing this problem and we must have accountability in our mutual funds.

Second, market timing, which involves short-term trading of mutual fund shares and exploits the time differential between foreign and U.S. markets. Although this practice is not inherently illegal, nearly all mutual funds ban it in their prospectuses. Fund directors are required to represent the interests of their shareholders, and only their interests. In reality, as the recent scandals have demonstrated, fund directors are not fulfilling their fiduciary duties to their shareholders. Funds should have more independent directors, fund management must not be spread too thin, to ensure proper oversight. If a mutual fund prospectus states a fund will not participate in market timing and then the fund proceeds to do so, that policy is not only disingenuous but it should be fraudulent. This level of investor fraud can not be accepted and the SEC must eliminate future abuses.

Finally, it concerns me that these practices may be the tip of the iceberg and have been camouflaged by the bull market. Mutual funds are a $7 trillion industry and with more than 50% of the American public invested in mutual funds there is the potential for investors to be hurt more so by these recent revelations than even the World Com and Enron scandals. I am not downplaying the problems that were in play there but I feel this issue is further reaching and could impact a greater number of investors in the long run. Some in the industry have stated market timing was an open practice, furthermore, some funds have even stated they participated in market timing on a limited level with clients to allow controversial trading as a way to control the improper practice. This bothers me.

I look forward to hearing from Mr. Spitzer and Mr. Cutler as well as all of our panelist today. There are a number of questions I hope we will be able to address in this hearing, specifically:

-Why has the SEC not been in the forefront of stopping abuses in the securities market;
-How long have these illegal practices been occuring and why have we not stopped them before now;
-Would a higher redemption fee help address market timing;
-Are mutual funds engaging in false marketing by allowing market timing practices when their prospectus ban it;
-What are the steps we must take to correct this problem?